

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFPH:STP
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date: MAY 17 2002

to: [REDACTED], Team Manager, [REDACTED], Team Coordinator,
[REDACTED], International Examiner

from: Eric Johnson, Senior Attorney, LMSB Area 3

subject: Byproduct Accounting for FSC Costs

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum replaces the memorandum on this issue dated May 6, 2002. This memorandum reflects further input by Chief Counsel National Office after their review of the prior memorandum.

ISSUE

Whether the taxpayer may assign zero cost to [REDACTED] in computing combined taxable income to determine the commission for the taxpayer's foreign sales corporation.

FACTS

The taxpayer, [REDACTED], Inc. ('[REDACTED]'), a [REDACTED] [REDACTED], is engaged, in part, in the processing, refining, merchandising, and distribution of [REDACTED]
[REDACTED]
[REDACTED]

One of [REDACTED] products is [REDACTED], which is used as [REDACTED] ([REDACTED]). [REDACTED] exports [REDACTED] [REDACTED] through its wholly owned foreign sales corporation (FSC), [REDACTED], [REDACTED] ([REDACTED]), which is incorporated in [REDACTED]. [REDACTED] computes the commission due to [REDACTED] under the FSC provisions

using the combined-taxable-income method.

[REDACTED]

[REDACTED]. Other various products are also produced through this processing.

For financial reporting purposes and for purposes of [REDACTED] consolidated federal income tax return generally (i.e. for purposes of [REDACTED] domestic sales of [REDACTED], [REDACTED] computes its cost of goods sold for the [REDACTED] products as follows. [REDACTED] is valued at market in opening and ending inventory. Because the [REDACTED] is valued at market, [REDACTED] generally realizes no income on sales of [REDACTED] (including on sales of [REDACTED] produced and sold in the same tax year). The other products are valued at lower of cost or market in opening and ending inventory; the cost for the other products is computed as the total production costs of the [REDACTED] less the market value of the [REDACTED].

[REDACTED] argues that its 'byproduct accounting' with respect to the [REDACTED] establishes a 'zero cost' in the [REDACTED] for financial reporting and federal income tax purposes. [REDACTED] argues that the Service should accept [REDACTED]'s byproduct method of accounting and give zero cost to the [REDACTED] for FSC purposes, i.e. not deduct any cost of goods sold amount for the [REDACTED] in computing combined taxable income. [REDACTED] cites Reg. §1.925(a)-1T(c)(6)(iii)(A), which reads as follows:

[T]he methods of accounting used by the FSC and the related supplier to compute their taxable incomes will be accepted for purposes of determining the amounts of items of income and expense (including depreciation) and the taxable year for which those items are taken into account.

The examining agent does not accept [REDACTED] position. The examining agent instead allocated a portion of the cost of goods sold of the [REDACTED] to the [REDACTED] based on relative sales and deducted this amount from combined taxable income.

ANALYSIS

1. [REDACTED] analysis is flawed.

It is unlikely that any form of byproduct accounting for inventories is valid for federal income tax purposes. The regulations generally mandate joint-costing of multiple products that result from a unitary production process. Reg. §1.471-7. (Additionally, I.R.C. §263A requires that all direct and indirect costs be accurately assigned to inventory.) Any endorsement of byproduct accounting is difficult to find in the reported case law. See, PPG Industries v. Commissioner, 55 T.C. 928 (1970); Woodward Iron Co. v. Patterson, 173 F.Supp. 251, 267 (N.D.A1. 1959). In the tax literature, the conclusion is generally reached at least that the Service is unlikely to accept byproduct accounting for federal income tax purposes. Matthew Bender, Federal Income Taxation of Inventories §§2.03[3], 8.03[2] (2000).

Moreover, [REDACTED] does not use true zero-cost byproduct accounting that would, under [REDACTED] reasoning, result in zero cost for the [REDACTED] in the computation of combined taxable income for FSC purposes. The most reasonable characterization of [REDACTED] method of accounting is that it assigns to the [REDACTED] a cost equal to market value. Under true zero-cost byproduct accounting, the entire production costs are assigned to the primary product, and the byproduct is valued at zero in opening and ending inventory. Under true zero-cost byproduct accounting, the taxpayer realizes income equal to the full sale price when the byproduct is sold.¹

If the Service were to 'accept' [REDACTED] method of accounting to assign cost for [REDACTED] with respect to combined taxable income for FSC calculations, the cost assigned to the [REDACTED] would be market value. This

¹ The two methods (for financial reporting) of byproduct accounting, zero-cost and market-cost, are noted in Federal Income Taxation of Inventories, supra §2.03[2].

would essentially reduce the combined taxable income to zero, and erase any FSC commission, with respect to [REDACTED] exports.

2. *The examining agent's approach is likely the most reasonable approach.*

The examining agent's approach of dividing the [REDACTED] processing costs between [REDACTED] and the other products based on relative sales is likely the most reasonable approach.

Reg. §1.925(a)-1T(c)(6)(iii)(C) requires that the cost of goods sold for computing combined taxable income for FSC purposes comply with I.R.C. §§471 and 472 and the regulations thereunder. As stated, Reg. §1.471-7 generally requires joint-costing of products that result from a unitary production process. The examining agent's approach is essentially a rough form of joint-costing.

The Service is not required to accept the taxpayer's method of accounting in computing combined taxable income for FSC purposes, but may make adjustments as necessary to avoid 'material distortions' between the related supplier and the FSC. Under Reg. §1.925(a)-1T(c)(6)(iii)(B), if the FSC and the related supplier are in a controlled group,

the FSC may not choose a method of accounting which, when applied to transactions between the FSC and other members of the controlled group, will result in a material distortion of the income of the FSC or of any other member of the controlled group.

Although 'material distortion' is not further defined, the only plausible meaning is that computation of combined taxable income for FSC purposes should correspond generally to economic substance - the computation should include income and deductions economically related to the product. See, General Dynamics Corp. v. Commissioner, 108 T.C. 107 (1997) (where taxpayer used completed-contract method of accounting, period costs deducted in prior tax years had to be deducted from combined taxable income for FSC purposes). Compare, Reg. §1.925(a)-1T(c)(6)(iii)(D) (costs other than costs of goods sold to be deducted from combined taxable income include all direct and indirect costs). The FSC provisions were originally enacted (as DISC provisions) in large part to

provide a straightforward proxy for the more exhaustive arm's length pricing analysis to establish economic substance under I.R.C. §482.

Congress intended that the pricing principles that govern the determination of the taxable income of a FSC comply with the GATT rules. If export property is sold to a FSC by a related person (or a commission is paid by a related principal to a FSC with respect to export property), the taxable income of the FSC and related person is based upon a transfer price determined under an arm's length pricing approach or under one of two formulae which are intended to approximate arm's length pricing.

Staff of Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 1054 (1984) (emphasis added). See also, H.R.Rep.No. 92-533, at 58 (1971), reprinted at 1972-1 C.B. 498, 529; S.Rep.No. 92-437, at 90 (1971), reprinted at 1972-1 C.B. 559, 609. In this case, neither [REDACTED] proposed zero cost for the [REDACTED] [REDACTED], nor the market cost for the [REDACTED] [REDACTED] that results from an accurate characterization of [REDACTED] method of accounting, results in combined taxable income that fairly reflects the economic costs associated with producing [REDACTED] [REDACTED].

[REDACTED]
, (b)(5)(AWP), (b)(5)(AC), (b)(5)(DP), (b)(7)a
[REDACTED]

CONCLUSION

The taxpayer should not be allowed to assign zero cost to [REDACTED] in computing combined taxable income to determine the commission for the taxpayer's foreign sales corporation.

The undersigned endorses the examining agent's alternative approach as described above.

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/s/Eric W. Johnson

By: _____
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